

Tax Issues Relating to Charitable Contributions and Organizations

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Summary

Prior to the financial crises and subsequent recession, the value of tax benefits for charitable contributions and organizations was estimated to be around \$100 billion per year. About half of this cost arose from the deductions for charitable contributions with the other half from exemptions of earnings of nonprofits. In 2010, the deduction for charitable contributions resulted in an estimated \$40 billion in federal revenue losses. On average, endowment investments in 2009 experienced losses, meaning that the federal government did not lose revenues from exempting asset returns from taxation. By 2011, these returns on endowments almost recovered to their prior levels, although they fell to approximately zero for 2012. Over the longer run, however, they are likely to earn a substantial return.

This report provides an overview of recent changes affecting tax-exempt and charitable organizations, while also discussing issues that may be of legislative interest in the future. The Pension Protection Act (P.L. 109-280) included a number of restrictions related to charitable contributions as well as restrictions on tax-exempt organizations. These changes are briefly surveyed.

In addition to changes regarding the treatment of charitable contributions and tax-exempt organizations that have been made in recent years, several issues may be considered in future legislation. A number of provisions related to charitable contributions were extended temporarily as part of the tax extenders in the American Taxpayer Relief Act of 2012 (P.L. 112-240). Most of the charitable extenders were contained in legislation first introduced in 2001. Some provisions were enacted temporarily in 2005; further provisions and extensions occurred in 2006, in the Pension Protection Act. These extenders include an individual retirement account (IRA) rollover, liberalized treatment of gifts of food inventory and conservation property, and two more technical provisions.

Limitations on itemized deductions have been proposed as part of the Fiscal Commission's recommendation. President Obama's budgets have proposed limiting itemized deductions' value, including charitable contributions, to 28%. Other types of limits may be considered as part of tax reform.

The Patient Protection and Affordable Care Act (PPACA; P.L. 111-148), in response to concerns regarding charity care and community benefits provided by tax-exempt hospitals, imposed new regulations.

Other issues that may arise reflect concerns about donor-advised funds and supporting organizations and educational institutions' endowments. For donor-advised funds and supporting organizations, the main issue is whether and how minimum distribution requirements should be imposed, alongside other new regulations. The decline in educational institutions' endowments had raised concerns that such declines may lead to tuition increases, although these assets have largely recovered. New reporting requirements for small tax-exempt organizations, enacted under the Pension Protection Act (P.L. 109-280) may cause a number of noncompliant tax-exempt entities to lose their tax-exempt status.

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Introduction

Historically, the value of tax benefits for charitable contributions and organizations was estimated to be around \$100 billion per year. This figure fell in recent years due to the economic recession and slow recovery. Although revisions to the treatment of charitable contributions and tax-exempt organizations that receive these contributions have been made in recent years, a number of issues remain unresolved. A number of provisions related to charitable contributions have been enacted on a temporary basis as part of the “tax extenders,” including an individual retirement account (IRA) rollover, liberalized treatment of certain gifts of inventory, and some other provisions. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended these provisions through 2011. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended most, but not all, of these provisions through 2013. The future of various charitable tax provisions beyond 2013 is uncertain.

This report also addresses a number of current policy issues relevant for various types of charitable organizations. Issues relating to donor-advised funds and supporting organizations, such as distribution requirements, remain relevant. Similar concerns about whether funds were being paid out at a high enough rate have also been directed at university and college endowments, where a combination of high returns and relatively low payout rates has led to rapid growth. Issues have also been raised about whether nonprofit hospitals provide enough charity care. The Patient Protection and Affordable Care Act (PPACA; P.L. 111-148) attempted to address some of these concerns by imposing new requirements on nonprofit hospitals while requiring the Secretary of the Treasury in conjunction with the Secretary of Health and Human Services to report to Congress on charity care provided by tax-exempt hospitals.¹

The President’s budgets proposed limiting the value of itemized deductions (which would include charitable contributions) to 28% of each dollar. The final report of the Fiscal Commission also recommended limiting the value of tax benefits associated with charitable contributions. A number of other proposals for caps or floors have also been made as a part of tax reform.

In addition to addressing the issues mentioned above, this report discusses the current tax benefits for tax-exempt and charitable organizations, reviews legislative changes that have taken place in recent years, and discusses potential future legislative issues. It focuses on deductions for charitable contributions, and on institutions that are generally eligible for deductible charitable contributions, such as social welfare organizations, educational institutions, nonprofit hospitals, and churches, along with conduits to those institutions such as private foundations, donor-advised funds, and supporting organizations.

Current Tax Benefits

The tax system provides a series of benefits for tax-exempt and charitable organizations. The most widely estimated and discussed is the deduction for charitable contributions, which is estimated in FY2014 to reduce federal revenue by \$46.4 billion.² This amount has declined compared with previous projects when most of the 2001 tax rates were made permanent.

¹ For more information, see CRS Report RL34605, *501(c)(3) Hospitals and the Community Benefit Standard*, by Erika K. Lunder and Edward C. Liu.

² Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, JCS-1-13, February 1, 2013. The categories for education and health are estimated separately at \$6.2 billion and \$4.6 billion, respectively. In 2011, of overall charitable contributions, not all of which are deductible because they are made by non-

Another important benefit is the exemption of earnings on assets from the income tax. As discussed below, although this benefit is difficult to estimate, it appears to be as large, and historically has been in the neighborhood of \$50 billion per year. For universities and colleges, these benefits are several times as large as the savings by donors from deducting charitable contributions. The value, however, fell temporarily given the reduction in earnings yields during the recent economic slowdown, had largely recovered, but fell again in 2012.³

Charitable Contributions

Not all tax-exempt organizations can receive tax deductible donations, but religious, educational, social welfare, health, animal protection, and similar organizations are eligible. In recent years, several revisions to the treatment of charitable deductions have been made, both to expand benefits and address potential abuses. Some of the provisions that expand benefits have become part of the “extenders,” provisions that are currently set to expire at the end of 2013.

Although charitable deductions are available to all taxpayers, individuals who take the standard deduction do not have a marginal tax incentive to give.⁴ Slightly over one-third of taxpayers itemize; about 30% deduct charitable contributions. Individuals’ contributions are, in general, limited to 50% of income for most charities, but are restricted to 30% for certain nonprofits, including non-operating foundations and institutions set up for the benefit of members (such as fraternal lodges). Individuals can contribute property as well as cash, and the contribution of appreciated assets has particularly beneficial treatment, since the value of most appreciated assets can be deducted without including the capital gains in income. (Some contributions of property are limited to the smaller of basis or fair market value, such as business inventory.) For that reason, gifts of appreciated property are limited to 30% of income for most general charitable organizations, and to 20% for organizations with more restricted giving limits, such as non-operating private foundations. Corporate contributions are limited to 10% of taxable income. Individuals can also deduct costs of volunteering for charitable purposes, including out-of-pocket expenditures, costs of using a vehicle, and travel costs when there is no significant personal element.

The treatment of charitable contributions has been of legislative interest. A series of proposals to expand charitable benefits were made in the past, beginning with President Bush’s 2000 presidential campaign, and followed by a series of bills introduced in Congress (referred to as the Community Solutions Act and the CARE Act). The centerpiece of the initial proposal was to allow charitable deductions for non-itemizers. This provision, which was relatively costly compared to other proposals, was scaled back with ceilings and floors, and ultimately not adopted. A number of more limited proposals were considered and some were adopted, largely on a temporary basis (part of temporary provisions referred to as the “extenders” that are continually reauthorized). Proposals and enacted legislation placing restrictions on charitable contributions were largely motivated by potential abuses, which led to some changes in the law. These included

itemizers, almost a third (32%) are to religious organizations, 13% are to education, 12% to human services, 9% to grantmaking foundations, 8 % respectively to health and international, 7% to public society benefit, 4% to arts, culture and humanities, 3% to environment and animals, 3% unallocated, and 1% grants from foundations to individuals. Reported on the National Park Service website, data from Giving USA 2012, at http://www.nps.gov/partnerships/fundraising_individuals_statistics.htm.

³ See data from National Association of College and University Business Officers (NACUBO)—Commonfund study at http://www.nacubo.org/Research/NACUBO-Commonfund_Study_of_Endowments/Public_NCSE_Tables.html.

⁴ The standard deduction does not impose a penalty, as it is an option that can be used when it is greater than the total sum of itemized deductions.

the lack of documentation of cash contributions, but largely focused on gifts of property, where the valuation of the property or even the existence of a true gift may be questioned.

Broad reform proposals have also suggested restricting charitable deductions to make incentives more efficient, both from an economic and administrative perspective, by only allowing charitable deductions in excess of a floor. More recently, charitable contributions may be affected by overall limitations on itemized deductions through general tax reform.

Tax Exemption of Earnings

A less visible, but nevertheless important, benefit is that tax exemption allows organizations to accumulate assets without paying tax on earnings.⁵ Estimates discussed below suggest that the revenue loss from this tax benefit may be larger than that associated with charitable contributions deductions. If charitable contributions were spent quickly, this benefit would be minimal. If contributions are held as assets and invested, the tax exemption may confer significant benefits. There are several ways in which donations are invested rather than spent. Some types of active tax-exempt organizations maintain assets in the form of endowments, particularly educational institutions. Private foundations are often originally funded with a large donation and pay out a small share of assets (required to be at least 5%, however). Two other types of institutions are similar to private foundations in that they do not directly engage in activities and accumulate assets from which they make payments: supporting organizations and donor-advised funds. All of these types of asset accumulating institutions have been the subject of legislative interest.

Prior to the recent recession, revenue losses associated with allowing organizations to accumulate assets tax-free had increased substantially with the growth of educational institution endowments. At some institutions, earnings were substantial relative to payout rates. During FY2007 (which ended in June 2007 for most institutions), approximately \$25 billion would have been raised if endowment earnings alone were subject to the corporate tax.⁶ This is more than three times as large as the revenue loss for charitable donations to all educational institutions, which was approximately \$7 billion in 2007. The ratio of revenue cost of the asset earnings to charitable contributions is probably smaller for other types of nonprofits. Nonetheless, the revenue cost of

⁵ The unrelated business income tax, or UBIT, is imposed on business activities unrelated to the charitable purpose, but it does not apply to investment earnings such as dividends and interest.

⁶ For FY2007 (ending in June of 2007) endowments of universities totaled \$411 billion, and earned a return of 21.5% according to the National Association of College and University Business Officers (posted at <http://www.nacubo.org/x2376.xml>). At a 35% tax rate, this amount totals to \$31 billion (\$411 billion times 0.215 times 0.35). Based on the allocation of assets (about 60% to 70% in equity investments), standard shares in capital gains (60%) and shares of gains unrealized (50%), about 20% would be unrealized capital gains. The total loss would be about \$25 billion (\$31 billion times 0.80). The only other readily available data source of assets and earnings of specific charities is in the survey of large charitable institutions in the *Chronicle of Philanthropy* ("Special Report: Jitters Among Strong Returns," pp. 6-11, June 24, 2008). Adding the assets of institutions outside of education indicated that these large non-educational institutions had endowments about 40% the size of all educational institutions, with about three quarters attributable to foundations, implying an additional revenue cost of around \$10 billion, for a total of \$35 billion. This estimate is incomplete, however, as only a limited number of charities are included and not all income is from endowments. For a more comprehensive number, some estimates of passive income are included in the national income accounts. Earnings for educational institutions for FY2006, a year with comparable data, were \$52 billion. Although the income concepts are not precisely the same, in calendar year 2005 (which ended approximately six months earlier) total rents, dividends and interest reported in the National Income and Product Accounts ascribed to nonprofits and retained were \$64 billion (Mark Ledbetter, Comparison of BEA Estimates of Personal Income with IRS Estimates of AGI, Survey of Current Business, November 2008, p. 38) and, if the share of capital gains were assumed to be the same as endowment investments, total income would be \$106 billion, with the total for all nonprofits roughly twice the amount of educational institution endowment earnings. Hence, the total revenue cost would be about twice as large as the loss from exempting endowments, or about \$50 billion.

exempting asset earnings for all charitable organizations was likely as high as \$50 billion prior to the recession, about the same size as the cost of the charitable deduction.

Returns on educational endowments were -18.7% in FY2009 and -2.5% over the 2007 through 2009 three-year period.⁷ Over the 10-year period, endowments earned a net return of approximately 4%. The recent economic downturn highlights how revenue losses associated with the tax-free accumulation of assets are susceptible to economic conditions. Revenue loss will fluctuate as returns to assets fluctuate.

For FY2011, however, endowment returns had largely recovered, and the lost revenue for endowment earnings for educational institutions was projected at \$22 billion, with overall costs were close to their FY2007 values.⁸ Returns, however, fell to virtually zero (-0.3%), due in part to large losses on international equities and small gains on domestic equities. These markets should eventually recover, however.

Congress also addressed some issues associated with tax-exempt organizations themselves. Some of this concern was directed at circumstances where tax deductible donations are made to organizations that act as conduits and do not have charitable activities. Private non-operating foundations, recipients of donations that make grants to active organizations, are required to pay out 5% of assets. Donor advised funds and supporting organizations, however, had no payout requirements. These organizations were the subject of legislative interest, not only because of concerns about payout rates, but also about the possibilities of using these organizations, which were not subject to self-dealing rules as restrictive as foundations, for private benefit. Some changes for these organizations were adopted, but major changes, such as payout requirements, were not in all cases; instead, Congress authorized Treasury studies and decisions in the aftermath of those studies is uncertain.⁹

Expanding Benefits for Charitable Contributions and Organizations

Although numerous legislative proposals have been introduced since 2001 directly relevant to the charitable sector, few of these proposals have become public law. The American Taxpayer Relief Act of 2012 (P.L. 112-24) was the latest to continue most of the charitable extenders (through 2013). The 111th Congress extended through 2021 these charitable provisions that had been allowed to expire as part of the extenders package in the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The charitable extenders, which had been allowed to expire at the end of 2009, had last been extended by the 110th Congress as part of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). The 111th Congress

⁷ National Association of College and University Business Officers, "Educational Endowments Returned -18.7% in FY2009," press release, January 28, 2010, available at http://www.nacubo.org/Documents/research/2009_NCSE_Press_Release.pdf.

⁸ Educational endowments were \$417.4 billion, and the rate of return was 19.2% in FY2011. See data and press release at NACUBO, <http://www.nacubo.org/Documents/research/2011NCSEPublicTablesEndowmentMarketValues319.pdf> and http://www.nacubo.org/Documents/research/2011_NCSE_Press_Release_Final_Embargo_1_31_12.pdf. However, the return fell to virtually zero for GY2012.

⁹ See CRS Report R42595, *An Analysis of Charitable Giving and Donor Advised Funds*, by Molly F. Sherlock and Jane G. Gravelle, for a discussion of the Treasury Report and further analysis of data.

also enacted legislation to accelerate tax deductions for charitable contributions made to Haiti's earthquake victims.¹⁰

The 109th Congress enacted a number of pieces of legislation with provisions to promote charitable giving. Much of this legislation was aimed at disaster relief.¹¹ The Pension Protection Act of 2006 (P.L. 109-280) contained a number of provisions that restricted charitable giving, including new reporting requirements for tax-exempt organizations; new requirements on donor-advised funds, supporting organizations, and credit counseling organizations; and enhanced incentives for charitable giving, such as the tax-free distributions from IRA accounts for charitable purposes.¹²

This section summarizes the tax proposals liberalizing charitable contributions and briefly reviews the issues in most cases. It is followed by a section summarizing the tax proposals restricting charitable contributions and organizations. Each proposal considered in this section is identified as not adopted, temporary (adopted as a temporary provision without expectation of extension), extender (adopted with an expiration date as part of the extenders proposals), or permanent. Note that further details of provisions enacted are contained in the Joint Tax Committee's "Blue Books," that summarize legislation.¹³

Provisions Considered But Not Adopted

In recent years, a number of provisions have been included in various proposals, but ultimately have not been adopted. These include a deduction for non-itemizers, a reduction in the foundation excise tax, and an increase in the income limit on corporate deductions. However, a proposal to replace the disallowance of tax-exempt status for unrelated business income in a charitable remainder trust with an excise tax was adopted in 2006.

Deduction for Non-Itemizers

The most significant charitable contributions proposal, in scope and revenue, considered in recent Congresses was a deduction for non-itemizers. Under current law a taxpayer can either itemize deductions (the major deductions are charitable contributions, excess medical expenses, mortgage interest, and state and local income and property taxes) or choose the standard deduction. The standard deduction is advantageous if the amount of the standard deduction is larger than total itemized deductions.¹⁴

When President George W. Bush first proposed extending the deduction for charitable contributions to non-itemizers in 2001 no restrictions were imposed. Most legislative proposals contained some limitation on this deduction, either in the form of a cap (a limit on the amount

¹⁰ For additional background, see CRS Report R41036, *Charitable Contributions for Haiti's Earthquake Victims*, by Molly F. Sherlock.

¹¹ See the Tsunami Relief Act of 2005 (P.L. 109-1), the Katrina Emergency Relief Act of 2005 (P.L. 109-73), and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135).

¹² A detailed summary of the charitable provisions in the Pension Protection Act of 2006 from the Committee on Ways and Means is available at <http://waysandmeans.house.gov/media/pdf/taxdocs/072806charitable.pdf>.

¹³ These documents can be found on the Joint Committee's website <http://www.jct.gov/>. The legislation discussed in this report is summarized in two volumes: *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-1-05, *General Explanation of Tax Legislation Enacted in the 109th Congress*, JCS-1-07, and *General Explanation of Tax Legislation Enacted in the 110th Congress*, JCS-1-09.

¹⁴ Non-itemizers were allowed a limited deduction for charitable contributions from 1981-1986, a provision which was enacted as part of the Economic Recovery Act of 1981 (P.L. 97-34).

that could be deducted) or a floor (where only contributions above a certain threshold could be deducted). Although a number of proposals were contained in legislation introduced in recent years, extending the deduction for charitable giving to non-itemizers has not been enacted. Although the 2006 Pension Protection Act (P.L. 109-280) did include a number of charitable giving incentives, a deduction for non-itemizers was not included in this piece of legislation.

Modifications to the charitable deduction have been proposed as part of broader tax reform or deficit reduction strategies. President Obama's Fiscal Commission recommended replacing the charitable deduction with a 12% nonrefundable tax credit available to all taxpayers.¹⁵ Under this proposal, the credit would only be available for donations above a 2% of adjusted gross income (AGI) floor.¹⁶ The 2005 President's Advisory Panel on Federal Tax Reform proposal on overall tax reform also included in its plans an extension of the deduction to non-itemizers, but added a floor of 1% of AGI, for both itemizers and non-itemizers.¹⁷

The Congressional Budget Office (CBO) has also discussed proposals to curtail the charitable giving deduction. A proposal that would limit deductions to donations above 2% of AGI for itemizers would generate an estimated \$219 billion in additional revenues over 10 years.¹⁸

The CBO has also looked at extending the charitable deduction to non-itemizers. A non-itemizer's deduction with a \$200 cap for married couples filing jointly (\$100 for individual filers) would cost \$8.2 billion over 10 years. A \$500/\$250 cap is estimated to cost \$31.3 billion over 10 years.¹⁹

The main objective of extending the charitable deduction to non-itemizers was to increase charitable giving. Charitable provisions were, however, considered after the 2001 tax cuts which involved considerable revenue costs. Caps were seen as a means to constrain the revenue loss. At the same time, while the deduction for non-itemizers may increase giving, its effects would be limited because of the cap, and the dollars of charitable giving induced per dollar of revenue loss would be smaller, particularly with a small cap. In addition, the provision would increase complexity for taxpayers who do not itemize.

Floors also limit the revenue cost, but increase effectiveness per dollar of revenue lost (relative to a provision without a floor) and simplify the tax code because taxpayers with small amounts of contributions would not qualify. Even without a cap, the deduction may not induce additional giving as large as the revenue loss because the responsiveness of taxpayers, particularly lower and moderate income taxpayers, to incentives may be small.²⁰

¹⁵ The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>.

¹⁶ Congressional Budget Office, *Budget Options: Volume 2*, August 2009, p. 193, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

¹⁷ U.S. Government Printing Office, President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System*, November 2005.

¹⁸ Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, March 2011, p. 150, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12085/03-10-reducingthedeficit.pdf>.

¹⁹ Congressional Budget Office, *Budget Options: Volume 2*, August 2009, p. 195, <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf>.

²⁰ See CRS Report RL31108, *Economic Analysis of the Charitable Contribution Deduction for Non-Itemizers*, by Jane G. Gravelle. The effects of alternative approaches on revenues and charitable giving were also addressed in Congressional Budget Office, *Effects of Allowing Nonitemizers to Deduct Charitable Contributions*, December 2002.

Reducing the Foundation Investment Income Excise Tax

Current law imposes a 1% tax on investment income of foundations, and an additional 1% if the foundation does not make a certain minimum distribution (based on average distribution rate over the previous five years), or has been subject to a tax for failure to distribute in the previous five years. Past legislative action has sought to remove the additional 1% tax.²¹ Legislation introduced in the 111th Congress, H.R. 4090 and S. 676, would have set a single tax rate of 1.32% on the investment income of foundations.

Private foundations, whose contributors (or their families) retain the right to direct the distribution of funds, have been subject to greater scrutiny, in part because of the possibility of the donor (or family) obtaining a private benefit. Foundations are required to distribute 5% of their assets each year (or pay a penalty), but the tax is credited against that distribution.

If the foundation is just making the minimum distribution, every dollar of tax reduction should be funneled into distributions because the tax is credited against the deduction. Since the tax and the actual distribution sum to a fixed amount, a fall in the tax will result in a rise in the amount distributed to other organizations. Moreover, the moving average rule that imposes the additional 1% tax if the foundation does not distribute at the average rate of the last five years discourages a large contribution in a particular year because it increases the hurdle for future avoidance of the tax. Proponents of current proposals to impose a fixed 1.32% tax rate on the investment income of foundations highlight that doing so would remove the disincentive for foundations to make large one-time payouts, often necessary to address natural disasters and other crises.²² The reduction in the investment tax should also make private foundations more attractive to givers in general, although that increased attractiveness might in part induce more contributions, and in part replace contributions that might have gone to other charities. The effects should be small, however, because the tax is small.

Proponents of reducing the tax also argued that it should be reduced because it brings in revenue that is in excess of IRS audit costs, which they indicate was the original purpose of the tax (which was introduced in 1969). The revenue stream from this tax has, however, been quite variable recently because it is heavily affected by the stock market. In any case, a reading of the legislative history indicates that while the Senate characterized the tax as an audit fee, the House referred more generally to the notion that private foundations should bear part of the cost of government generally because of their ability to pay (as well as viewing it in part as a user fee), and both objectives were cited in the bill's final explanation. It was reduced twice (in 1978 and 1984) based on the argument regarding costs of audit versus revenue.

Another argument made for eliminating the additional tax is the additional complication arising from it. At the same time, simplification does not require reduction in the tax; it could be converted to a larger flat fee.

²¹ A 2003 House proposal added a new provision that limited the counting of administrative costs as part of a foundation's minimum distribution requirement. Foundations are required to make a minimum distribution of 5%, but that 5% can currently include administrative costs (which currently have to be "reasonable"). As originally introduced earlier in 2003, the provision would have disallowed any administrative costs, but the proposal as reported allowed deductions for most administrative costs, with some exceptions. This provision was not enacted.

²² Stephanie Strom, "Senate Measure Seeks to Spur Foundations to Give More," *New York Times*, March 25, 2009, Late Edition.

Raising the Corporate Charitable Deductions Cap

Under current law corporations can deduct charitable contributions of up to 10% of income. Proposals introduced in the House in 2003 would have gradually raised the cap to 20% (by one percentage point each year beginning in 2004, reaching 15% in 2008-11, and 20% thereafter). The initial (107th Congress) provision would have raised the limit to 15%. This provision is relatively small, and most corporate giving already falls well under the cap; average giving is less than 2% of income.

Some question the appropriateness of corporate charity, since shareholders could make their own decisions about charitable giving. Allowing the deduction at the firm level is, however, more beneficial to the donor because both the corporate and individual taxes are eliminated. In some views, charitable giving by corporations is another management perk that might be excessive because of monitoring problems by shareholders (this problem is also called an agency cost problem). Others argue that corporations should be encouraged to give to charity and to be socially responsible. Economists have studied models in which charitable giving is part of the firm's profit maximizing behavior (e.g., by gaining the firm good will). Evidence on the effectiveness of the deduction is mixed, with time series studies showing a positive effect and cross section results not finding an effect.²³

Unrelated Business Income of Charitable Remainder Trusts

Current law provides tax deductions for some portion of a trust and income tax exemption on the earnings, if a remainder of the assets is left to charity (while paying income to a non-charitable donee, usually a spouse or other relative during an interim period). The trust's income, however, was no longer exempt from tax if the trust had unrelated business income. An alternative to liberalize the rule by providing for a 100% excise tax on any unrelated business income rather than loss of all tax exemption was adopted in 2006.

Disaster Provisions Enacted on a Temporary Basis

Several provisions were enacted in 2005 in response to disasters. The Tsunami Relief Act of 2005 (P.L. 109-1) allowed contributions made in January 2005 to be treated as made in the previous year (and therefore deductible on 2004 tax returns) to encourage giving for relief from the Tsunami that struck in 2004. The Hurricane Katrina Emergency Relief Act of 2005 (P.L. 109-73) adopted several provisions, effective through 2005, to encourage giving to Katrina victims. It allowed unlimited cash contributions for individuals (normally restricted to 50% of income). It also allowed unlimited contributions for corporations (normally restricted to 10% of taxable income) if contributions were made to aid Katrina victims. Charitable contributions made after the disaster were not subject to the phase out of itemized deductions. Mileage rates for deducting costs of using a vehicle for charitable purposes to aid Katrina victims were increased from 14 cents to 70% of the business rate of 48.5 cents. Reimbursements for these costs in excess of the mileage allowance were not included in income if the activity was for the aid of Katrina victims. The Gulf Opportunity Zone Act (P.L. 109-135) extended the benefits of higher limits to contributions to Hurricanes Rita and Wilma.

²³ See James R. Boatsman and Sanjay Gupta, "Taxes and Corporate Charity: Empirical Evidence from Micro-Level Panel Data," *National Tax Journal*, vol. 49, June 1996, pp. 193-213.

In 2010, Congress passed the Haiti Assistance Income Tax Incentive Act (HAITI Act; P.L. 111-126). This legislation contained provisions similar to those enacted following the Tsunami in 2004, allowing taxpayers to claim tax deductions for giving on the previous years' tax returns.²⁴

Provisions Now Part of the Extenders²⁵

A number of charitable provisions have been enacted on a temporary basis, and are now part of the tax extenders. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended five of the seven provisions through 2013, reinstating them retroactively for 2012. Previously, the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) retroactively extended all of the provisions, which had been allowed to expire at the end of 2009, through 2011. Prior to the most recent extension, the provision relating to donation of conservation property was last extended by the Food and Energy Security Act of 2007 (P.L. 110-234). Six others, including the IRA rollover provision, three provisions relating to donations of business inventory, a provision regarding the effect of a charitable donation on the basis of stock of small corporations that elect to be taxed as partnerships, and a provision eliminating the unrelated business income tax on arms-length rental payments to tax-exempt organizations from a related entity were extended by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). The two provisions not extended by P.L. 112-240 were those for business donations of computer equipment and books.

Contributions of Conservation Property

Another important set of provisions, originated in the Senate, expanded benefits for contributions for conservation purposes by lifting the cap on contributions as a percent of income. Gifts of appreciated property are deductible at the fair market value, but, for individuals, have lower limits (30% of income) than ordinary gifts such as cash (50% of income). The Pension Protection Act (P.L. 109-280) increased the limit for appreciated property contributed for conservation purposes to 50% for individuals. The provision increased the limit to 100% for farmers and ranchers, including individuals and for corporations that are not publicly traded. To qualify, land used or available to be used for agricultural or livestock production must remain available for such purposes. This provision expired at the end of 2007, but was extended for an additional two years in the Food, Conservation, and Energy Act of 2008 (P.L. 110-234) and for another two years by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The latest legislation, the American Taxpayer Relief Act of 2012 (P.L. 112-240) extended this provision through 2013, at an estimated cost of \$254 million. As noted above, lower income limits for gifts of appreciated property reflect concerns about the overstatement of fair market value and the deduction of amounts that have not been included in income.

IRA Rollover Provision

Currently, individuals aged 70½ and older are allowed to make tax free distributions from individual retirement accounts to charities. This provision was adopted on a temporary basis in the Pension Protection Act in 2006 but expired at the end of 2007, and is now extended through 2011. The treatment benefits non-itemizers, who would not otherwise be able to take a deduction.

²⁴ For additional background, see CRS Report R41036, *Charitable Contributions for Haiti's Earthquake Victims*, by Molly F. Sherlock.

²⁵ More information on the extenders can be found in CRS Report RL32367, *Certain Temporary Tax Provisions that Expired in December 2009 ("Extenders")*, by James M. Bickley.

Although this treatment may appear no different, for itemizers, from simply including the amounts in adjusted gross income and then deducting them as itemized deductions, it can provide several types of benefits even to those who itemize. This treatment reduces adjusted gross income, which can trigger a variety of phase-outs and phase-ins, including the phase-in of taxation of Social Security benefits. There are also income limits on charitable contributions: individuals can contribute no more than 50% of income in cash and no more than 30% in appreciated property. Because IRAs tend to be held by higher income individuals, the taxpayers might be somewhat more sensitive to the incentive to give; however, the law does not specify why this particular group of taxpayers was targeted for an expansion of charitable giving provisions. This provision was adopted in P.L. 109-280 with a \$100,000 annual limit. It was originally projected to cost \$238 million in the first year and \$856 million over 10 years. The latest two year extension in P.L. 112-240 has an estimated 10-year cost of \$1.28 billion.

Extending the Deduction for Food Inventory to all Businesses

Corporations that donate inventory to charity in general get a deduction for the cost (not the market value). A special rule allows businesses paying the corporate tax to also exclude half the appreciation (half the difference between market value and cost of production) if the inventory is given to an organization that directly passes it on to the ill, the needy, or infants, as long as the total deduction is no more than twice the cost. An important category of donations is food. There have been disputes between taxpayers and the IRS about how to measure the fair market value of food.²⁶ The charitable contributions proposals would have allowed unincorporated businesses (or businesses that are incorporated but do not pay the corporate tax) the additional deduction, and the fair market value of wholesome food would be considered the price at which the firm is currently selling the item (or sold it in the past), although this deduction would be limited to the corporate percentage cap on deductions in general. This provision's cost was relatively small.

The provision's objective was to create more equity among different types of taxpayers and resolve disputes (largely in the taxpayer's favor). However, as with the deduction of appreciated property, these rules allow firms to deduct amounts that have not been included in income. Although the provision is limited by allowing only one-half the appreciation, these products, if sold, would be taxed at full rates (rather than the lower rates imposed on individual capital gains). In addition, as with gifts of capital gain property, an important concern is the potential overstatement of market value. Firms may only be able to sell donated inventory at a much lower price because the product is damaged in appearance, is older, or has other characteristics that would require deep discounting to sell. Moreover, a firm with market power may not wish to sell all of its inventory because increasing supply will drive the price down more for a sale than a donation. It is possible that a provision that is extended to non-corporate businesses, which are smaller and more numerous, will be more difficult to monitor for compliance.

For inventory that cannot be practically sold, the barrier to a donation by the firm is the extra costs encountered in distributing the product. Thus, there is a tradeoff between creating an incentive and providing a windfall for the firm.

The Katrina Emergency Relief Act of 2005 (P.L. 109-73) provided treatment to unincorporated firms (not to exceed 10% of business income) through 2005 but did not make the other changes. The Pension Protection Act of 2006 (P.L. 109-280) extended the provision through 2007, and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended it through 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended

²⁶ See CRS Report RL31097, *Charitable Contributions of Food Inventory: Proposals for Change*, by Pamela J. Jackson.

this provision through 2011. P.L. 112-240 extended it for an additional two years with an estimated cost of \$314 million over 10 years.

Contributions of Computer Equipment

C corporations that donate computer technology or equipment to educational organizations or tax-exempt charities that support elementary and secondary education are eligible for a deduction. In concrete terms, this rule requires that no more than 50% of the cost is due to parts purchased elsewhere. The issues surrounding this provision are the same as those related to other contributions of inventory, such as food inventory.

The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the provision for two years. Most recently, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the provision through 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended this provision through 2011, with an estimated cost of \$350 million over 10 years. This provision was not extended by P.L. 112-240.

Contributions of Book Inventory

A provision that originated in the Senate extended the treatment of food inventories to book inventories for C corporations that donated to public elementary and secondary schools. As with all contributions of property, valuation may be an issue. Book publishers who have printed too many books may only be able to sell them at a discount, and perhaps a potentially deep one. This provision was enacted in the Katrina Emergency Relief Act of 2005 (P.L. 109-73) through 2005. The Pension Protection Act of 2006 (P.L. 109-280) extended the provision through 2007, and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended it through 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended this provision through 2011, with an estimated cost of \$53 million over 10 years. This provision was not extended by P.L. 112-240.

Basis of S Corporation Stock for Charitable Contributions

Under current law, a shareholder in a Subchapter S corporation (a corporation treated as a partnership) is allowed to deduct his or her pro rata share of any corporate contribution. At the same time, the taxpayer must decrease the basis of stock by that amount (which is a way of reflecting the effect on the shareholder's asset position). The Congressional proposals on charitable contributions provided that the taxpayer would not have to reduce basis in the stock to the extent a deduction is taken in excess of adjusted basis of the donated property (e.g., cost). This provision appears to be consistent with allowing a deduction for the market value of appreciated property without including the appreciation in income (a special benefit generally available to taxpayers). This provision's cost was relatively small. The Pension Protection Act of 2006 (P.L. 109-280) included this provision effective through 2007, and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended it through 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended this provision through 2011. P.L. 112-240 extended this provision through 2013, with an estimated cost of \$225 million over 10 years.

Unrelated Business Income: Related Party Payments

Charities are subject to a tax on unrelated business income. Rents, royalties and annuities are excluded from income subject to the tax except when received by a majority owned subsidiary. Among provisions included in the 108th Congress version of charity proposals was one to exclude

certain items (such as rent) received by a subsidiary from a tax on unrelated business income except for the excess over an arms-length price. As with other provisions, however, the determination of arms-length rents is not always straightforward when there are not closely comparable properties. This provision was adopted in the Pension Protection Act (P.L. 109-280), and applied to payments through 2007. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended it through 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended this provision through 2011. P.L. 112-240 extended this provision through 2013, with an estimated cost of \$40 million over 10 years.

Permanent Reduction in Excise Tax Reduction for Blood Collector Organizations

The Pension Protection Act of 2006 (P.L. 109-280) included a provision exempting qualified blood collectors from a variety of excise taxes, including communications taxes and taxes relating to fuels and vehicles. This provision is directed at the Red Cross.

Recent Restrictions on Charitable Donations and Organizations

Congress has considered many provisions in recent years aimed at preventing potential abuse, with many problematic areas identified by the Internal Revenue Service.²⁷ The Senate Finance Committee has investigated many compliance issues.²⁸ In 2004 and 2005, the Senate Finance Committee held hearings on the subject. Also, early in 2005, the Joint Committee on Taxation published a study on options to improve tax compliance that included a number of provisions relating to charitable contributions and tax-exempt organizations.²⁹

The concerns expressed in these hearings and studies focused on potential abuses of charitable organizations, on the valuation of gifts of property, and on certain types of organizations, including donor-advised funds and supporting organizations. These two types of organizations, like private foundations, permit contributions to build up an account without necessarily making a contribution. Private foundations, however, are subject to a 5% payout requirement and a number of special restrictions to prevent funds from being used for the benefit of the donor. Donor-advised funds are funds where the donor contributes to an account in an institution and the institution subsequently makes contributions, advised by the donor. Supporting organizations do not have a direct charitable purpose, but support organizations that do.³⁰

More broad ranging proposals to make the charitable contributions deduction more effective and less subject to claims of small undocumented deductions would have introduced a floor. Earlier proposals associated with expansions of the deductions to non-itemizers proposed dollar floors,

²⁷ See, for example, testimony of Mark Everson, Commissioner of Internal Revenue, Statement on Exempt Organizations, Enforcement Problems, Accomplishments and Future Directions before the Senate Finance Committee, April 5, 2005, at <http://finance.senate.gov/hearings/testimony/2005test/metest040505.pdf>.

²⁸ Summary of Senator Chuck Grassley's Non-Profit Oversight, November 20, 2007, at <http://finance.senate.gov/newsroom/ranking/release/?id=83f6b20e-3327-4619-8b92-36ce643ef5fe>.

²⁹ Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05, January 27, 2005, at <http://www.jct.gov/s-2-05.pdf>.

³⁰ Issues surrounding supporting organizations and donor-advised funds, as well as gifts of appreciated property, are discussed in the testimony of Jane G. Gravelle, on Charities and Charitable Giving: Proposals for Reform, before the Senate Finance Committee, April 5, 2005, at <http://finance.senate.gov/imo/media/doc/jgtest040505.pdf>.

but these proposals tended to focus on floors as a percent of income. As noted above, the Deficit Commission's proposal would create a charitable credit available to all taxpayers, subject to a floor of 2% of income. The 2005 President's Advisory Panel on Tax Reform proposed a floor equal to 1% of income. The Congressional Budget Office included a budget option for a floor of 2%.

Some changes were enacted in 2003 and 2004, but most of the restrictive provisions that were adjusted were part of the Pension Protection Act of 2006.

Restrictions on Charitable Contributions

A series of restrictions on charitable donations, aimed at reducing abuse, were adopted in 2006. Most of these provisions related to gifts of appreciated property, where the gift is deducted at fair market value. These gifts account for about 25% of all donations, and for much larger shares of donations of higher income taxpayers. For taxpayers with incomes above \$10 million, gifts of property account for 50% of contributions. Taxpayers with incomes above \$1 million account for 18% of cash gifts, but 40% of property gifts.³¹ This provision is especially beneficial to the donor because a deduction is allowed for the full value, while the appreciation is not taxed. While the valuation of contributions such as publicly traded stock is straightforward, the valuation of gifts where value is not easily assigned presents some issues for tax compliance. If the taxpayer can value donated property at an excessive value, it is even possible to benefit privately from making a contribution rather than by selling the property.

The President's Advisory Commission on Tax Reform proposed in 2005 that individuals be allowed to sell appreciated property and donate the proceeds without paying the capital gains tax, to address the valuation problem.³²

During the debate on the treatment of gifts of appreciated property, some broad changes were discussed. For example, the Joint Committee on Taxation presented an option in its study to allow only the basis to be deducted for gifts of property that were not publicly traded. A Senate staff discussion paper, among a broad array of options discussed, considered "baseball arbitration," where the court can only find for the taxpayer's original value or the IRS value, which would create an incentive to limit any overstatement of value.³³ Although these provisions were not adopted, a number of changes were, as detailed below.

Vehicle Donations and Gifts of Intellectual Property

Growing concerns about the abuse of donations of used vehicles and of patents and other intellectual property led to several revisions in the American Jobs Creation Act of 2004 (P.L. 108-357). According to IRS data, in 2003, \$2.3 billion of deductions associated with vehicles was deducted, for those taxpayers who had non-cash contributions of \$500 or more.³⁴ Often charities

³¹ These data are reported in the testimony of Jane G. Gravelle, on *Charities and Charitable Giving: Proposals for Reform*, before the Senate Finance Committee, April 5, 2005, at <http://finance.senate.gov/hearings/testimony/2005test/jgtest040505.pdf>.

³² U.S. Government Printing Office, President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System*, November 2005.

³³ For a discussion, see the testimony of Jane G. Gravelle, on *Charities and Charitable Giving: Proposals for Reform*, before the Senate Finance Committee, April 5, 2005, at <http://finance.senate.gov/hearings/testimony/2005test/jgtest040505.pdf>.

³⁴ Janette Wilson and Michael Strudler, "Individual Non-Cash Charitable Contributions 2003," Internal Revenue Service, *Statistics of Income Bulletin*, spring 2006, p. 59.

resold vehicles at a much smaller value than the value deducted by the taxpayer.³⁵ The revision required that, for vehicles with a value of \$500 or more, the deduction is restricted to the value of resale, if the vehicle is resold rather than used or refurbished by the charity. The act also extended to corporations the requirement of an appraisal for a donation of property (other than readily valued property such as cash, inventory, and publicly traded securities) of \$5,000. This appraisal is not required in the case of resale of a vehicle by an organization. It also required appraisals to be attached to tax returns for gifts valued at \$500,000 or more. Finally the law restricted the donation of intellectual property, which could be valued at fair market value, to the lesser of basis (roughly cost of developing or purchasing) or market value.

Contributions of Historical Conservation Easements

As a general rule, a taxpayer cannot take a deduction for a partial interest in a property. However, gifts of conservation or historical easements (where the taxpayer restricts the use of property) may be made. Their value is the reduction in the value of the property due to the easement. One concern that arose was that taxpayers were making gifts of easements on historical facades (the front of the building), which involve an agreement not to change the facade, when the regulations in the historical district already imposed this restriction. Thus there could be no effect on property values. A provision in the Pension Protection Act required these easement to be limited to buildings but to apply to the entire exterior (not just the facade), and that an appraisal be supplied.

Contributions of Taxidermy Property

Press reports suggested that individuals involved in big game hunting were receiving deductions for contributing their mounted trophies at inflated prices which were often resold at a lower price.³⁶ In addition to the revenue effects, concern was expressed by environmental and animal rights groups. The Pension Protection Act restricted the deduction to the cost of mounting the trophy; thus, cost does not include the cost of hunting trips.

Recapture of Tax Benefit if Not Used for Exempt Purpose

The Pension Protection Act requires individuals who give gifts of appreciated property to be subject to a recapture tax if the property is not used by the organization for its exempt purposes and is sold within three years. If the property is sold in the same year, the donor generally deducts basis (cost); if sold after that year, the donor must include in income the difference between fair market value claimed and the basis.

Deductions for Contributions of Clothing and Household Items

Contributions of used clothing and household items present difficulties because these items are difficult and time intensive to value and audit. They are significant in value, however. In 2003, these contributions were estimated at \$8.6 billion for those with \$500 or more of non-cash contributions; clothing accounted for two thirds of the total.³⁷ The amounts would be larger if taxpayers with contributions of less than \$500 in cash were included. The Pension Protection Act disallows the deduction for items not in good used condition or better and provides the Internal

³⁵ See, for example, the report by the GAO, *Vehicle Donation: Benefits to Charities and Donors but Limited Program Oversight*, GAO-04-73, November 2003, at <http://www.gao.gov/new.items/d0473.pdf>.

³⁶ See Zachary A. Goldfarb, "Pension Bill Also Curbs Hunter's Breaks," *Washington Post*, August 5, 2006.

³⁷ Janette Wilson and Michael Strudler, "Individual Non-Cash Charitable Contributions 2003," Internal Revenue Service, *Statistics of Income Bulletin*, spring 2006, p.59.

Revenue Service with broad authority to disallow deductions. Items valued more than \$500 may be deducted if not in good used condition or better if accompanied by an appraisal. Household items do not include items such food, art, antiques, jewels and gems, and collections.

Recordkeeping Requirements

The Pension Protection Act changed the rule that allowed substantiation of small cash contributions by a written record or log. All cash contributions must be substantiated by a bank record (e.g., cancelled check) or receipt from the organization.

Contributions of Fractional Interests

Taxpayers could deduct contributions of fractional interests in art although they could not deduct a contribution of a future right to the art.³⁸ For example the taxpayer could contribute a 10% interest in an art work to a museum, and receive a deduction for 10% of the value of the art. The museum would have the right to possess the art for 10% of the year. There were several concerns about this tax treatment. First, a court decision (*Winokur v. Commissioner*) settled in 1988 found that physical possession was not required to make a fractional interest donation, only the right to physical possession.³⁹ The Internal Revenue Service challenged this case, but the court found for the taxpayer. As a result, individuals could keep art work in their possession, perhaps through their lifetimes, or even pass the property on to their heirs, while still securing a charitable contribution deduction. The second is a concern that the possession or display of the art by the museum itself enhances the market value of the work, effectively increasing the value of the art work, and the value of future deductions or sales compared to an outright gift. Another set of issues relates to estate taxes. Estate taxes can be reduced by a reduction in value due to minority discounts—the view taken by the courts that an ownership of a minority interest in an asset loses some value because of lack of control. The minority ownership does not, however, affect the value of the charitable deduction for income or estate tax purposes. The Pension Protection Act requires physical possession by the donee; requires the gift to be completed within 10 years or at the donor's death, whichever comes first; disallows fractional donation of a property that is not wholly owned by the donor, or the donor and donee for later gifts (the Secretary of the Treasury can make an exception if multiple owners donate similar fractional shares); and requires that subsequent fractional shares are limited to market value at the time of the original donation. If

³⁸ The magnitude of these donations is difficult to determine as is the degree of potential abuse. Certain museums that had wealthy patrons using this process could lose significant donations, although these art works may not necessarily be exhibited constantly because of fractional ownership. According to a news report, the San Francisco Museum of Modern Art received 48% of donations in fractional giving in the fiscal year ending in 2001, although the share fell to 10% the next year and has recently climbed to 20% (See Sarah Duxbury, "SFMOMA Turns 'Timeshare' Gifts into an Art Form," *San Francisco Business Times*, August 19, 2005). In general, most discussions of fractional giving in the news seem to suggest that having the donor keep the art is not uncommon. (See Rachel Emma Silverman, "Joint Custody for your Monet," *Wall Street Journal Online*, July 7, 2007). A law journal article, in discussing the proposal to require physical possession stated: "This would effectively put an end to fractional gifts of large sculptures that are difficult and expensive to move every year. It will also substantially curtail fractional gifts of paintings since it is usually not the best idea to constantly move a fragile painting every year." This discussion also suggests that physical possession is an important issue. See Ralph E. Lerner, "Fractional Gifts of Art," *New York Law Journal*, April 24, 2006. A New York Times article stated "in practice, many museums have waived their right to possess pieces at all except when they needed them for exhibitions." Jeremy Kahn, "Museums Fear Tax Law Changes on Some Donations," *New York Times*, September 13, 2006.

³⁹ *Winokur v. Commissioner*, 90 T.C. 733 (1988), James Winokur contributed fractional interests in paintings to the Carnegie Museum, and the museum had a right to possess the paintings but never did. This case is summarized in Marylynne Pitz, "Fractional Donations Require Close Look at the Law," *Pittsburgh Post-Gazette*, July 24, 2005: <http://www.postgazette.com/pg/05205/541620.stm>.

these restrictions are not met the tax savings from the deduction are recaptured with interest and a 10% penalty.

Penalties on Overstatements of Valuations

This provision lowered the thresholds for imposing penalties for overstatements of value for the income tax and understatement for the estate tax. It also established a separate penalty structure for appraisers.

Restrictions on Tax-Exempt Organizations

A few provisions were enacted during the 108th Congress that applied to tax-exempt organizations, but most provisions were enacted in the 109th Congress, primarily in the Pension Protection Act in 2006. Some of these provisions affect organizations that are tax exempt but are not charitable organizations.

Terrorist Activities

The Military Family Tax Relief Act of 2003 (P.L. 108-121) provided for automatic suspension of the tax-exempt status of organizations placed on the designated list of terrorist organizations or supporters of terrorism. Normally, suspension of tax-exempt status requires or permits administrative and judicial proceedings.

Leasing Activities

In a provision not directly affecting contributions or tax-exempt status, but which nevertheless might have consequences for tax-exempt organizations, the American Jobs Creation Act of 2004 also restricted the ability of parties leasing arrangements to obtain favorable tax treatment.⁴⁰

Penalties for Tax-Exempt Organizations in Prohibited Tax Shelters

Some tax shelter operations require participation of a tax-exempt entity. This provision imposed penalties on exempt organizations that are a party in a prohibited tax shelter transaction. It was enacted in the Tax Increase Prevention and Reconciliation Act (P.L. 109-222) in 2006.

Life Insurance

Investments in life insurance are subject to beneficial tax treatment, including exemptions when assets are paid at death and deferral of tax on investment earnings. State laws restrict the holding of an interest in life insurance if there is no insurable interest (e.g., a relationship with the insured). Some states exempt charities from the insurable interest and some allow insurable interests for private investors if there is also a charitable organization involved. The Pension Protection Act does not directly affect these relationships but requires temporary reporting on life insurance arrangements by exempt organizations (for two years) and mandates a study of this issue by the Treasury Department.

⁴⁰ A discussion of this issue can be found in CRS Report RL32479, *Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities*, by Maxim Shvedov. (Out of print; available from the author to congressional clients upon request.)

Penalties and Penalty Taxes

A series of penalties applies to certain actions of charitable and tax-exempt organizations. The most punitive penalty for an inappropriate action, in general, is to revoke the exempt status. There are a series of intermediate sanctions that generally impose monetary penalties. An excess benefit tax applies to transactions of charitable welfare organizations (other than private foundations) and social welfare organizations. Private foundations are subject to taxes or penalties for self-dealing, failure to distribute income, on excess business holdings, for investments that jeopardize the charitable purposes, and for taxable expenditures (such as lobbying or making open-ended grants to institutions other than charities). The Pension Protection Act increased those taxes and penalties.

Credit Counseling Agencies

Nonprofit credit counseling agencies obtained tax-exempt status because their purpose was largely to educate and counsel consumers, and perhaps offer some tailored debt management plans as well. A rapid growth of tax-exempt credit counseling agencies occurred in the 1990s. Press reports and investigations suggested that there was widespread abuse and that these new firms were not primarily being used for educational purposes but were used to enroll individuals into payment plans. The Internal Revenue Service performed audits and revoked tax-exempt status for some agencies. The Pension Protection Act established a series of standards and requirements for exempt credit counseling agencies and treated debt management plans as an unrelated business, with earnings subject to the unrelated business income tax.

Expanding the Base for Imposing Foundation Excise Taxes

As discussed above, foundations are subject to excise taxes on investment income. The Pension Protection Act expanded the base to include additional types of income—such as income from financial contracts, annuities, and certain capital gains.

Defining Conventions or Association of Churches

A convention or association of churches is not required to file an information return and is subject to provisions generally applicable to churches. The Pension Protection Act specified that a convention or association of churches would not fail to qualify because there are individual members.

Information Reporting: Organizations Not Filing Annual Returns

Although exempt organizations are generally required to file information returns, certain organizations are exempt (these include small organizations, certain religious organizations and certain government related organizations). The Pension Protection Act, requires these organizations to report contact information to the Internal Revenue Service (i.e., organizational title, address) using the Form 990-N, also known as the e-postcard.⁴¹ Organizations failing to file for three years will have their tax-exempt status revoked.⁴²

⁴¹ More information is available from the Internal Revenue Service at <http://www.irs.gov/charities/article/0,,id=169250,00.html>.

⁴² The Internal Revenue Service provides answers to frequently asked questions regarding automatic revocation of tax-exempt status for entities failing to file informational returns. This information is available at <http://www.irs.gov/charities/article/0,,id=221600,00.html>.

Disclosure to State Officials

The Secretary of the Treasury is required to notify the appropriate State officer of a refusal to recognize an organization as a charitable one that may receive tax deductible contributions, revocation of that status, and the mailing of a notice of deficiency for certain taxes. Returns and records relating to this disclosure must be made available for inspection. This provision in the Pension Protection Act revises the rules for disclosure of tax information to state authorities, including the disclosure, upon request, of a notice of proposed refusal to recognize, revoke, or issue a deficiency, names and addresses of applicants, and associated returns.

Disclosure of the Unrelated Business Income Tax Return

Organizations are required to make information and application materials available for public inspection. The Pension Protection Act requires disclosure to be applied to the return reporting unrelated business income.

Donor-Advised Funds and Supporting Organizations

The Pension Protection Act authorized Treasury Department studies of donor advised funds and supporting organizations and made other changes to their status. Donor advised funds are funds where donors make contributions and the institution holding the accounts makes contributions to charitable organizations with the advice of the donor. Although the donor has no legal control, in practice the donor's wishes are likely to be respected. Supporting organizations do not actively engage in charitable activities but support organizations that do by contributing funds to them. Supporting organizations fall into three types: Type I controlled by the charitable organizations, Type II, controlled by the same entity controlling the charitable organization and Type III, related to the charitable organization. Type III organizations may support many charitable organizations.

These types of organizations had many features in common with private foundations, but were not subject to self-dealing rules and other restrictions (meant to prevent the donor from receiving a private benefit) or payout requires (meant to keep the organization from accumulating funds without paying out some amount for charitable purposes). There was some evidence that abuses were occurring and that, in some cases, little was being paid out. In addition to the mandated studies, other changes, including the following, were made.

Donor-advised funds eligible for charitable contributions were specifically defined in the law. They were prohibited from providing benefits to the donors, they were required to have a governance structure if grants were made to individuals (such as a scholarship fund), and contributions of closely held businesses had to be sold within a short period of time.

Supporting organizations must indicate which type they are and certain Type III organizations will eventually be subject to a minimum payout (with the Treasury Secretary making such a determination through issuance of regulations). In August 2007, the Treasury issued proposed regulations and invited comment, indicating the same minimum distribution rule applying to foundations (5% of assets) is expected to be applied.⁴³

In general, the Pension Protection Act prohibits supporting organizations from making grants or loans, or paying compensation, to substantial contributors. Supporting organizations cannot receive contributions from persons who control the organization and from private foundations if the supporting organization is controlled by significant persons at the foundation. They are not

⁴³ For more information, see IRS Notice 2007-21, available at <http://www.irs.gov/pub/irs-drop/n-07-21.pdf>.

eligible for the rollover treatment for individual retirement accounts (IRAs). Type III organizations must also file additional information and cannot support foreign nonprofits.

Current Issues Surrounding Charitable Deductions and Organizations

There are a number of tax issues regarding charitable deductions and tax-exempt organizations that may be of interest in the 113th Congress. The charitable extenders discussed above are set to expire at the end of 2013. The President's Fiscal Commission suggested modifying the charitable deduction as part of comprehensive tax reform to address the deficit and fiscal sustainability. President's Obama's budgets have proposed to limit the value of itemized deductions, including charitable contributions, to 28%. Limits on itemized deductions may be considered as part of income tax reforms.

In addition, there has been interest, as indicated by hearings and by activities of the Senate Finance Committee in the tax-exempt status of nonprofit hospitals and in university endowments. The Patient Protection and Affordable Care Act (PPACA; P.L. 111-148) imposed a number of new requirements on 501(c)(3) tax-exempt hospitals. The Finance Committee has also shown interest in specific tax-exempt organizations, such as media related ministries.

Provisions enacted under the Pension Protection Act continue to raise issues of interest to the tax-exempt sector. The findings of Treasury studies on donor-advised funds and supporting organizations may have broader implications for the charitable sector generally. In 2010, a number of small tax-exempt organizations had their tax-exempt status revoked after failing to meet information reporting requirements enacted as part of the Pension Protection Act. These issues are discussed in greater detail in the sections below.

The Extenders

Table 1 reports the expected revenue cost of extending each of the charitable provisions contained in the American Taxpayer Relief Act of 2012 (P.L. 112-240). There are two issues associated with these charitable benefits "extenders": whether they are effective or appropriate provisions, and, if so, whether they should be temporary when most of the provisions of the tax code are permanent. The specific issues associated with each of these provisions were discussed earlier.

Table 1. Charitable Provisions Among the Extenders

Provision	FY2013-2022 Revenue Cost of Extension (Millions of Dollars)
Tax-free distributions from IRAs for charitable purposes	\$1,280
Charitable deduction for contributions of food inventory	\$314
Special rule for S corporations making charitable contributions	\$225
Increased contribution limit for contributions of appreciated real property for conservation	\$254
Special treatment of certain payments to controlling exempt organizations	\$40

Source: Joint Committee on Taxation, JCX-1-13, January 23, 2013.

One criticism that could be made of using temporary provisions for charitable purposes is that although the budgetary cost is smaller for a provision extended only a year at a time, the intention is to continue the provision. This practice causes the official projected budget deficits to be smaller than they will likely be, takes up the time of the Congress with considering the extenders, and creates some uncertainty for taxpayers.

On the other hand, an argument that could be made in favor of temporary provisions is that a temporary provision makes reconsideration of the merits and design of the provisions more likely. Evidence suggests, however, that relatively few temporary provisions have been revised. One exception is the R&D tax credit, which has been the subject of some major revisions. Nevertheless, it could be argued that the temporary nature of these provisions is conducive to better tax policy because provisions are reconsidered even though they are rarely revised.

Limiting Itemized Deductions

Various proposals have been put forth that would limit the tax benefits associated with charitable contributions. The Fiscal Commission recommended replacing the charitable deduction with a 12% nonrefundable tax credit, available only for contributions above 2% of income. President Obama's budgets have proposed limiting the value of itemized deductions (which would include charitable contributions) to 28% of each dollar. Thus, under the proposal, taxpayers in the top brackets (33%, 35%, and 39.6%) would have each dollar of deductions reduced by 28 cents on the dollar rather than a reduction based on their marginal tax rate (for example, 33 cents).

Although there has been concern expressed about the effect on charitable giving, especially during difficult economic times, the provision would not affect giving today if it does not go into effect immediately. In fact, enactment today of a future change would be expected to increase contributions as taxpayers seek to make contributions before the cap is imposed. Estimates of permanent effects on charitable giving from the 28% limitation suggest the effects would be relatively small, generally around 1%.⁴⁴

The itemized deduction cap overall was projected to raise \$584 billion over 10 years (FY2013-FY2022).⁴⁵ This estimate assumed that 33% would rise to 36% and the 35% tax rate would rise to 39.6% whereas the permanent rates adopted in the American Taxpayer Relief Act of 2012 (P.L. 112-240) only changed part of the 35% rate to 39.6%, so the gain would be smaller. Internal Revenue Service statistics suggest that charitable contributions account for about a quarter of itemized deductions at higher income levels.

Other potential limits on total itemized deductions or other tax expenditures that could become a part of tax reform, such as a dollar cap or a percentage of income cap.⁴⁶ In general, if the desire is

⁴⁴ CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by Jane G. Gravelle and Donald J. Marples. Paul N. Van de Water, Proposal to Cap Deductions for High Income Households Would Reduce Charitable Deductions by Only About 1%, Center on Budget Policy and Priorities, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2700>. "How Changes in Tax Rates Might Affect Itemized Charitable Giving," by Deb Partha and Mark O. Wilhelm, The Center on Philanthropy at Indiana University found a reduction of less than 1%, http://www.philanthropy.iupui.edu/docs/2009/2009_TaxChangeProposal_WhitePaper.pdf.

⁴⁵ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

⁴⁶ See, for example, the proposal by Martin Feldstein, to cap benefits from certain tax expenditures, including itemized deductions, at 2% of income. Martin Feldstein "Raise Taxes, Not Tax Rates," *New York Times*, May 4, 2011, at <http://www.nber.org/feldstein/nyt05042011.html>. Governor Romney also discussed the possibility of dollar caps on deductions during the 2012 Presidential campaign. See Richard Rubin, "Romney \$17,000 Deduction Limit Part of

to encourage charitable contributions, a floor would retain much of the incentive effect while a cap would eliminate it.

Nonprofit Hospitals

The Patient Protection and Affordable Care Act (PPACA; P.L. 111-148) imposed a number of new requirements on 501(c)(3) tax-exempt hospitals. Prior to the enactment of PPACA, the tax writing committees, and especially Senator Grassley, had shown interest in nonprofit hospitals. A major concern was the degree of charity care and whether nonprofit hospitals are providing benefits that justify their charitable and tax-exempt status. The Congressional Budget Office released a study in 2006 that found that nonprofit hospitals overall provided only slightly more charity care than for-profit hospitals.⁴⁷ The Senate Finance Committee held hearings on the topic “Taking the Pulse of Charitable Care and Community Benefits at Non-Profit Hospitals,” on September 13, 2006, and the House Ways and Means Committee held hearings on “The Tax Exempt Hospital Sector,” on May 26, 2005.

In a staff discussion draft released July 18, 2007, by Senator Grassley, the following concerns were raised about nonprofit hospitals: establishing and publicizing charity care, the amount of charity care and community benefits provided, conversion of nonprofit assets for use by for-profits, ensuring an exempt purpose for joint ventures with for-profits, governance, and billing and collection practices.⁴⁸ Subsequently, on October 24, 2007, Senator Grassley authorized a round-table to discuss the draft. Also in July 2007, the IRS released an interim report on nonprofit hospitals, where they found that the median share of revenues spent on charity care was 3.9% and almost half of hospitals spent 3% or less. The average was 7.4%.⁴⁹

Under PPACA, tax-exempt hospitals are subject to four new requirements.⁵⁰ First, hospitals will be required to conduct a “community health needs assessment” and adopt an implementation strategy to meet those needs.⁵¹ Second, hospitals are required to written financial assistance and emergency care policies. Third, hospitals may not charge individuals eligible under the financial assistance policy more than the lowest amount charged to those with insurance coverage. Finally, hospitals are required to make reasonable efforts to determine if an individual is eligible for financial assistance before beginning extraordinary collections actions.

PPACA also requires the Treasury Secretary to review the community benefit activities of tax-exempt hospitals. Additionally, the Treasury Secretary, in consultation with the Secretary of Health and Human Services (HHS) will be required to report annually to Congress information on charity care, bad debt expenses, unreimbursed costs for services, and community benefit activities.

Three-Cap Concept,” *Bloomberg*, October 4, 2012, at <http://www.bloomberg.com/news/2012-10-03/romney-17-000-deduction-cap-first-of-three-part-proposal.html>.

⁴⁷ Congressional Budget Office, *Nonprofit Hospitals and the Provision of Community Benefits*, December 2006.

⁴⁸ *Tax Exempt Hospitals: Discussion Draft*, at <http://finance.senate.gov/press/Gpress/2007/prg071907a.pdf>.

⁴⁹ Internal Revenue Service, *Hospital Compliance Program Interim Report*, at http://www.irs.gov/pub/irs-tege/eo_interim_hospital_report_072007.pdf.

⁵⁰ For additional background, see CRS Report RL34605, *501(c)(3) Hospitals and the Community Benefit Standard*, by Erika K. Lunder and Edward C. Liu.

⁵¹ This provision becomes effective for taxable years starting after March 23, 2012.

University and College Endowments

Universities and colleges are classified as charitable organizations eligible to receive deductible contributions, and, also, as tax-exempt entities, do not pay tax on their investments. As indicated above, prior to the financial crises and subsequent recession, the benefit of exempting endowment income of colleges and universities from taxes was estimated at around \$25 billion. At \$25 billion, this exemption was worth more than three times the benefit of charitable deductions to all educational institutions. Historically, these high yields were coupled with relatively low payout rates. For the fiscal year that ended June 2007, endowments were \$411 billion and the average rate of return was 21.5%. The payout rate was 4.6%. As a result of those relationships along with contributions, endowments grew 18.4% between FY2006 and FY2007 (about three and a half times the growth rate of the economy), continuing an ongoing trend from recent years.

The losses in college and university endowment funds experienced during the recession have raised new issues of concern. In FY2009, losses were 18.7% on average.⁵² Prior to the onset of the recession, Senator Grassley, ranking member of the Finance Committee, discussed concern that colleges were not using enough of their endowments funds to provide an affordable education.⁵³ Tuition rates remain an issue of interest. In 2010, following the release of data on college and university endowment losses, Senator Grassley noted:⁵⁴

I hope colleges won't rely on double-digit losses as a reason to raise tuition or freeze student aid. Many of them relied on some risky investments, like hedge funds, to get big gains in recent years, and now those strategies are causing losses. ... Pay-out rates over the last decade rarely topped 5 percent, even when investment returns were in double digits.

Donor-Advised Funds and Supporting Organizations

The two basic issues associated with donor-advised funds and supporting organizations were possibilities of receiving private benefit by donors and payout rates. As noted above, while some changes were enacted, others remain possible. Although payout requirements are planned (administratively) for Type III supporting organizations, there are no payout requirements for donor-advised funds and for other supporting organizations. These issues might be revisited when Treasury completes its studies.⁵⁵

The Treasury was directed to study specific issues: whether deductions for contributions to donor-advised funds and supporting organizations are appropriate given the use of the assets or benefits to the donor, whether donor-advised funds should have a distribution requirement, whether the retention of rights by donors means that the gift is not completed, and whether these issues apply to other charities or charitable donors.

This Treasury study provided considerable data but it is not clear what policy implications should be. A CRS report that reviewed the study and updated the data in the case of donor-advised funds indicated that aggregate payout requirements for the overall fund would not have much effect,

⁵² National Association of College and University Business Officers, *Commonfund Study of Endowments*, available at http://www.nacubo.org/Research/NACUBO_Endowment_Study.html.

⁵³ Charles E. Grassley, "Wealthy Colleges Must Make Themselves More Affordable," *Chronicle of Higher Education*, May 29, 2008, <http://finance.senate.gov/newsroom/ranking/release/?id=c1b59ac6-5fb9-4770-8050-10c4e99d8b1e>.

⁵⁴ Office of Senator Grassley, "Grassley: Students, Families Shouldn't Bear Brunt of College Endowment Losses," press release, January 27, 2010, http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=24983.

⁵⁵ See Nick Tarlson, "Donor Advised Funds: Prepare for Closer Scrutiny," *Journal of Accountancy*, 2008, http://www.aicpa.org/pubs/jofa/jan2008/donor_advised_funds.htm.

and that an effective payout requirement would need to be applied to each individual account. It also suggested, although the data are limited, that many accounts do not pay out contributions.⁵⁶

Reporting Requirements and Exempt Status Revocation

The Pension Protection Act of 2006 implemented new reporting requirements for tax-exempt organizations with revenues of less than \$25,000.⁵⁷ Entities failing to file required information returns (Form 990-N, also known as the e-postcard) with the IRS for three consecutive years will have their tax-exempt status revoked. Thus, revocations took place for the first time in 2010.

There are more than 714,000 tax-exempt organizations registered with the IRS that would be subject to new reporting requirements. As of July 2010, 41% of these organizations had yet to file.⁵⁸ There are various reasons why registered tax-exempt organizations may not file the required information returns. Some of these organizations may no longer exist. The required filings will help the IRS determine which organizations remain active. On the other hand, active organizations may not file if they are not aware of the new filing requirements. The IRS extended the filing deadline to October 15, 2010 to give charities that would have been required to file earlier in the year more time to comply with this new law. Further, the IRS has posted a list of organizations in danger of losing their tax-exempt status on their website.⁵⁹

Specific Sectors Including Media-Based Ministries

Over a period of time the Senate Finance Committee has examined specific charitable organizations or groups as well as specific charitable donation practices. Some of these investigations were spurred by media reports and some by IRS studies; they have led to both legislation and self-correction by entities involved.

In 2007, Senator Grassley sent inquiries to several media-based ministries for information on their finances. Religious organizations do not have to file the information (990) forms that other tax-exempt organizations have to file, so generally it is difficult to obtain information on the activities of these tax-exempt entities. The results of this inquiry were announced on January 6, 2011. While not all ministries provided the requested information, enough information was gathered for Senator Grassley to determine that internal reforms were taking place.⁶⁰

⁵⁶ See CRS Report R42595, *An Analysis of Charitable Giving and Donor Advised Funds*, by Molly F. Sherlock and Jane G. Gravelle.

⁵⁷ The IRS website provides details on the information tax-exempt entities are required to report to be in compliance with this new law. See <http://www.irs.gov/charities/article/0,,id=177792,00.html>.

⁵⁸ Amy Blackwood and Katie L. Roeger, *Here Today, Gone Tomorrow: A Look at Organizations that May Have Their Tax-Exempt Status Revoked*, The Urban Institute: National Center for Charitable Statistics, July 8, 2010, <http://www.urban.org/UploadedPDF/412135-tax-exempt-status.pdf>.

⁵⁹ See <http://www.irs.gov/charities/article/0,,id=225889,00.html>.

⁶⁰ For additional information and access to the full reports, see The Office of Senator Grassley, "Grassley Releases Review of Tax Issues Raised by Media-based Ministries," press release, January 6, 2011, http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=30359.

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